INDEX

CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 410

TRICO PRODUCTS CORPORATION, *Petitioner*

v.

GEORGE T. McGOWAN, Collector of Internal Revenue for the Twenty-eighth District of New York

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 861-892) is reported in 67 F. Supp. 311. The opinion of the Court of Appeals (R. 916-919) is reported in 169 F. 2d 343.

JURISDICTION

The judgment of the Court of Appeals was entered on July 21, 1948. (R. 920.) A petition for

a rehearing was denied on August 17, 1948. (R. 935.) The petition for certiorari was filed on November 12, 1948. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Did the lower courts err in finding and holding that in 1936 and 1937, the taxpayer "was availed of for the purpose of preventing the imposition of the surtax upon its shareholders" and shareholders of the Trico Securities Corporation "through the medium of permitting [its] earnings and profits to accumulate instead of being divided or distributed" within the meaning of Section 102(a) of the Revenue Act of 1936?

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra,* pp. 16-21.

STATEMENT

Taxpayer brought this suit against the Collector of Internal Revenue to recover income and excess profits taxes for the calendar years 1936 and 1937, in the sum of $1,543,609.03, plus interest. (R. 3-12.) The case was tried to the court without a jury. (R. 18.) The District Court found that in 1936 and 1937, taxpayer permitted its gains and profits to accumulate beyond the needs of its business and that in those years it was availed of for the purpose of preventing the imposition of sur-

taxes upon its shareholders and the shareholders of the Trico Securities Corporation through the medium of permitting its gains and profits to accumulate instead of being divided or distributed. (R. 908.) The court therefore concluded that the surtaxes imposed by the Commissioner under Section 102 (a), Revenue Act of 1936, were properly assessed and collected. (R. 909.) That being the sole issue, judgment was rendered for the Collector. (R. 910-911.) On appeal the Court of Appeals affirmed. (R. 916-920.)

The pertinent facts as found by the District Court or as stipulated by the parties may be briefly summarized as follows:[1]

Taxpayer was a New York corporation organized in 1920 to take over the assets of the Tri-Continental Corporation. (R. 893.) In 1936 and 1937, the manufacture and sale of automatic windshield wipers comprised about 90% of taxpayer's business. (R. 894, 902.) In those years it was a flourishing, prosperous and well established corporation having secured 100% of the windshield wiper business without competition in that line. It owned its own plant and equipment and had no debts or outstanding bond issues of consequence. (R. 902.) Its basic patents on its vacuum operated windshield wipers had until January 25, 1942, to run and they had been judicially determined to be valid in 1927.

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[1] The District Court found *inter alia* all the facts as stipulated by the parties. (R. 908.)

(R. 894.) In 1936 and 1937, its patent position had become impregnable and it was well protected by improvement patents and trade-marks. (R. 902-903.) It made the component parts used in its products in its own factory and there assembled the parts into finished products. It held a ten year contract entered into in August, 1933, with General Motors under which it acquired the sole right to supply that company with its products and such contract with several years to run, together with arrangements with other large companies, assured taxpayer of a large and steady income extending many years into the future. Its sales were practically all on a cash basis and it was not required to and did not maintain reserves in any substantial amount for bad debts. Its stock was steadily advancing in value and control was reasonably assured in the same group which in past years had been responsible for its successful operations. In 1936, double windshield wipers were first installed on automobiles which greatly increased taxpayer's business and its prospects of future income. (R. 903.)

In 1936 and 1937, taxpayer's net book profits after all deductions including federal taxes and excluding dividends and interest on Government, state and municipal bonds was $3,891,090.94 and $3,417,347.03, respectively. The percentage of the net profit to net sales for those years was 31.7 and 27.1, respectively. (R. 902.)

It had consistently made large and fairly steady net profits in all years from 1927 through 1939, ranging in amounts from $895,588.70 in 1932, to $3,891,090.94 in 1936. Only in 1932 did these profits fall below one million dollars. In 1929 they exceeded two million dollars, and in 1935, 1936, 1937 and 1939 they exceeded three million dollars. (R. 902.)

As of December 31, 1936, taxpayer's accumulated gains and profits were not less than $10,913,737.07, and at the end of 1937 not less than $12,745,212.92.[2] (R. 901.)

The balance sheets of taxpayer show that taxpayer's principal assets were as follows (R. 645):

Years	State and Municipal Obligations	United States Obligations	Stocks of Domestic Corporations	Buildings, Machinery and Equipment
1936	$1,731,935.41	$ 6,914,093.41	$ 341,169.45	$3,165,875.57
1937	$1,726,847.42	$ 6,398,390.28	$1,407,992.40	$4,760,795.77
1941	$3,478,214.28	$12,649,467.18	$2,687,910.02	$5,637,706.69

[2] Its accumulated gains and profits for other later years were as follows (R. 648, 657)

1938 — $14,018,763.59
1939 — $16,516,605.36
1940 — $20,284,364.72
1941 — $23,032,160.99

These figures represent the book surplus shown in the analysis of taxpayer's surplus account (R. 648) plus transfers from surplus shown in the analysis of taxpayer's capital stock account (R. 657). The District Court found that similar book transfers had no effect on accumulated gains and profits and should be added in determining the correct amounts of such gains and profits. (R. 900-901.)

Taxpayer's total assets were $16,923,728.55 in 1936; $18,106,521.95 in 1937, and $30,614,223.90 in 1941. (R. 645.) Taxpayer's investments in United States, state and municipal bonds and stocks and other investments were as follows (R. 901):

1936 — $ 9,036,743.27
1937 — $10,192,815.47
1941 — $18,949,883.88

Taxpayer's original capital was $1,750,000. (R. 900.) The balance of its undistributed net income for the years here involved was as follows (R. 901):

1936 — $2,201,028.88
1937 — $1,831,475.85

In September, 1927, taxpayer's stockholders entered into an arrangement with a banking syndicate for a recapitalization of taxpayer under which a total of 675,000 shares of stock were issued to taxpayer's 21 stockholders in exchange for taxpayer's outstanding stock. A majority of these stockholders had been interested in the business from the start. Of the stock thus received, 225,000 shares were entitled to share ratably in all dividends. (That stock is referred to in the court's findings as "free" or "unrestricted" stock.) The remaining 450,000 shares received by the stockholders were entitled to share ratably in that part only of dividends which should be declared in excess of $2.50 in any one year on each of the free

shares. (Those 450,000 shares are referred to in the findings as "restricted" stock.) The banking syndicate purchased 175,000 of the unrestricted shares which had been distributed to the stockholders and paid therefor $4,225,000 in cash to the stockholders. The stockholders retained the rest of the unrestricted shares and all the restricted shares. (R. 895, 897.) The agreement contained provisions for releasing the restricted shares as free shares by blocks under a formula based on net earnings of taxpayers in years beginning in 1928. (R. 895-896.) The restricted shares were at first placed in a voting trust. (R. 895.) The trust could be ended by the concurrence of stockholders holding a 60% interest in the trust. The agreement contained no provisions limiting dividends on the unrestricted stock to $2.50 a share annually or in any other amount. It contained no provisions requiring that the assets of the taxpayer would be built up to any given or stated value. (R. 896-897.)

The agreement was carried out according to its terms. As a result the original stockholders held 450,000 shares of restricted stock and 50,000 shares of free stock while the remaining 175,000 shares of free stock were sold to the public through the bankers. (R. 897.)

In 1929 the voting trust was terminated by the 21 old stockholders owning the restricted stock which had been placed in the voting trust. (R. 896.)

Trico Securities Corporation was organized in

1929 to take the place of the voting trust. It acquired all of the then restricted stock amounting to 337,500 shares from the original stockholders who thereupon became stockholders of Trico Securities Corporation in proportion to their holdings of the restricted shares. (R. 897-898.)

Up to the time of the recapitalization in 1927, taxpayer had outstanding 7,999.91 shares of stock held by 21 stockholders of which John R. Oishei and Dr. Peter Cornell owned 4,519.955 shares or considerably over one-half of the stock. (R. 668.)

In 1936 and 1937 Trico Securities owned a majority of taxpayer's stock. (R. 669.)

In 1936 and 1937 six of taxpayer's original stockholders owned 85% of the outstanding stock of Trico Securities Corporation. (R. 898.)

Taxpayer paid dividends on its free stock for the years 1928 to 1941, in the amount of $2.50 a share each year except in 1936 and 1937 in which years on account of the undistributed profits tax law it declared an additional dividend on both free and restricted stock of $2.50 a share in 1936 and $1.375 a share in 1937. (R. 900.)

In 1936 out of its net income of $1,184,506.81, it spent $813,283.42 for plant and equipment (R. 900) and in 1937, out of its net income of $3,792,244.62 it spent $1,623,322.42 for that purpose (R. 901).

While taxpayer's basic patents expired in 1942, it had prior to the tax years here involved constantly made and protected the development of its

products by improvement patents. The financial cost of the patents was small and in view of the general uptrend of taxpayer's earnings, its stable and assured business, and the fact that its plant would remain after the patents had expired either for conversion or continued operation in the manufacture of its old products, it was not shown that the accumulated gains or profits were necessary in order to develop new products or do business after the patents expired in 1942. (R. 904.) Taxpayer acquired its sole supplier position not because of its large surpluses, but because it made the best windshield wipers. (R. 904.) In 1936 and 1937, any necessary expenses in protecting its patent rights could easily have been paid out of its current earnings. (R. 905.)

Taxpayer did not manufacture its product commonly known as the "Liftomatic" (a device for raising and lowering car windows by the touch of a button) in 1936 and 1937. That product was not shown to the public until 1940 and although taxpayer had a patent on the product and had been working on it for several years the first model was not completed until 1938. (R. 905.) The court found that the evidence was insufficient to show that preparation for the manufacture of the "Liftomatic" played any important part in the accumulations of the gains and profits for 1936 and 1937. Taxpayer's cost for experimental work in those years inclusive aggregated only $85,897.82. The

evidence failed to show how much of those sums, if any, was used to develop the "Liftomatic". (R. 906-907.) The complete "Liftomatic" on which taxpayer later based its hopes of great profits was apparently unknown to it in 1936 and 1937. It was not shown that the large expenditures now contemplated in developing the "Liftomatic" played any important part in the retention of the accumulated earnings and profits for those years. (R. 907.)

From the beginning of taxpayer's corporate existence it has been controlled by John R. Oishei and Dr. Peter Cornell through their ownership of over 50% of the stock of Trico Securities Corporation. In 1936 and 1937, if taxpayer had distributed all of its net earnings and Trico Securities Corporation had distributed the amounts received by it as taxpayer's stockholder, the income taxes of Oishei and Cornell would be increased as follows (R. 907):

Oishei

1936 — $358,832.52
1937 — $328,061.64

Cornell

1936 — $326,871.45
1937 — $305,796.26

The six largest stockholders of taxpayer (including Oishei and Cornell) were all in the higher tax brackets and in case of such distributions would have been subject to additional taxes of $962,944.80 in 1936 and $890,833.23 in 1937. (R. 907.)

ARGUMENT

The taxes here involved were levied under Section 102 (a), Revenue Act of 1936 (Appendix, *infra*), which imposes a surtax upon corporations which are availed of for the purpose of preventing the imposition of surtaxes upon their shareholders or the shareholders of another corporation through the medium of permitting earnings and profits to accumulate instead of being divided or distributed.

Section 102 (b), Revenue Act of 1936 (Appendix, *infra*), provides that the accumulation of earnings and profits beyond the reasonable needs of the business constitutes *prima facie* evidence of the purpose to avoid surtax. The question presented is essentially one of fact. *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282, 291, 294; *Helvering* v. *Stock Yards Co.*, 318 U. S. 693, 700, 701.

The decisions below are supported by the evidence and are correct. The District Court found that the taxpayer was a flourishing, well established corporation which had acquired 100% of the windshield wiper business which comprised about 90% of its business and had no competition in this line. It was without debts of consequence; owned its own factory and equipment; its patents had been judicially established; it held a favorable sole supplier contract with General Motors; it had consistently been realizing extremely large net earnings and profits for many years which it had been accumulating in liquid form rather than distributing them as dividends. Its accumulated profits were

over ten million dollars in 1936, and over twelve million dollars in 1937. (R. 901.) They were over twenty-three million in 1941. (R. 647-648, 657.)

The evidence further supported the court in its findings and conclusions that notwithstanding the denials of taxpayer's president, the corporate purpose back of the accumulations of earnings and profits was tax avoidance. *Helvering* v. *Stock Yards Co.*, 318 U. S. 693, 701. The District Court found that more than 50% of taxpayer's stock was owned by Trico Securities Corporation. (R. 907.) Two of taxpayer's stockholders owned over 59% of the stock of the Trico Securities Corporation (R. 676) and thereby controlled taxpayer through Trico Securities. The court further found that if taxpayer's net earnings and profits for 1936 and 1937 had been distributed as dividends, and Trico Securities had distributed its earnings and profits in those years, those stockholders would have been subjected to additional taxes totaling over $1,300,000, and taxpayer's six principal stockholders would have been subjected to additional taxes totaling $1,800,000.[3] (R. 907.) This is clearly sufficient to

[3] The taxpayer also unsuccessfully resisted the assessment of surtaxes levied against it for 1934 and 1935, based on an identical statute and assessed on almost identical facts. *Trico Products Corp.* v. *Commissioner*, 46 B. T. A. 346, affirmed, 137 F. 2d 424 (C.C.A. 2d), certiorari denied, 320 U. S. 799, rehearing denied, 321 U. S. 801. The facts involved in that case were found by the District Court to be similar to those here involved with only relatively minor differences. (R. 888-890.)

support the trial court's findings. *Helvering* v. *Stock Yards Co., supra.*

Taxpayer argues (Pet. 9-15) that the purpose behind the accumulations was to enable it to make investments in securities in order that its earnings might be increased so as to permit the release of additional shares of restricted stock pursuant to a formula based on net earnings of the company. (R. 365-371.) The contention was rejected by the courts below. The Court of Appeals correctly pointed out (R. 918) that the conservation of earnings to release restricted shares did not serve a business corporate need though such action may have been beneficial to the holders of the restricted stock. Even if it is here admitted, for the sake of argument, that the release of the restricted shares was one of the dominant purposes back of the accumulations, it remains that the court found that the accumulations were also motivated by tax avoidance purposes. The statute clearly does not require that the tax avoidance motive be the sole or even the dominant purpose back of the accumulations.[4]

Taxpayer also contends (Pet. 7-8, 17) that the accumulations were necessary to develop its product known as the Lift-O-Matic. That contention was also considered and rejected by the District

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[4] *Nipoch Corp.* v. *Commissioner*, 36 B. T. A. 662, 668; *Trico Products Corp.* v. *Commissioner*, 137 F. 2d 424, 426 (C.C.A. 2d).

Court (R. 880-882) and by the Court of Appeals (R. 918) principally on the ground that the product, which had not yet passed its embryonic stage in 1936 and 1937, in fact played no important role in taxpayer's fiscal program in those years.

The other grounds relied upon (Pet. 17-18) were all advanced below and correctly rejected by the lower courts. The District Court's findings rejecting such grounds are well supported by the evidence.[5]

There is no more occasion for further review here than in the earlier case involving the same basic facts for 1934 and 1935 in which this Court denied certiorari (see fn. 3, *supra*, p. 12).

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[5] Under the terms of the recapitalization agreement back in 1927 between the bankers and taxpayer's stockholders, 175,000 shares of stock in taxpayer were sold to the bankers for $4,225,000 which was retained by the stockholders (R. 895-897.) It seems clear that these old stockholders would have left these proceeds in the company if there were any substance to taxpayer's contentions that large accumulations were needed to enable taxpayer to maintain its sole supplier position with the large automobile companies or for other business purposes as alleged.

CONCLUSION

There is no conflict. The decision is correct. The petition for certiorari should be denied.

Respectfully submitted,

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December, 1948.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this title) upon the net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed—

* * *

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company, or that the earnings or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

* * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 102-1. *Taxation of corporation formed or utilized for avoidance of surtax.* Section 102 imposes (in addition to other taxes im-

posed by Title I) a graduated income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. However, personal holding companies, as defined in section 351, being taxed separately in accordance with the provisions thereof, are excepted from taxation under section 102. The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation.

* * *

ART. 102-2. *Purpose to avoid surtax.*—The Act provides two *prima facie* presumptions of the existence of a purpose to avoid surtax. The fact (1) that any corporation is a mere holding or investment company, or (2) that the earnings or profits are permitted to ac-

cumulate beyond the reasonable needs of the business, constitutes *prima facie* evidence of a purpose to avoid the individual surtax. A corporation having practically no activities except holding property, and collecting the income therefrom or investing therein, shall be considered a holding company within the meaning of section 102. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or a marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 102.

The assumed purpose to avoid the individual surtax is subject to disproof by competent evidence like any other question. Proof of the purpose, therefore, depends upon the particular circumstances of each case. In other words, the purpose may be evidenced by circumstances other than the presumptions specified in the Act. A corporation is subject to taxation under section 102 when it is formed or availed of for the purpose of preventing the imposition of the individual surtax regardless of whether it is a mere holding or investment company, or whether the accumulations, if any, are in excess of the business needs. On the other hand, the statutory presumptions will be overcome if the corporation can show, by a disclosure of all the facts, that it was neither formed nor availed of for the purpose

of avoiding the individual surtax, but the mere fact that it distributed a large portion of its earnings for the year in question is not sufficient to overcome the presumption. All the circumstances which might be construed as evidence of the purpose can not be outlined. Among other things the following will be taken into consideration in determining the existence of such purpose: (1) Dealings between the corporation and its shareholders such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders and (2) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business.

ART. 102-3. *Unreasonable accumulation of profits.*—An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the

business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of earnings or profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance although not in legal form the business of the first corporation. Earnings or profits of the first corporation put into the second through the purchase of stock or otherwise may, therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business. The business of one corporation may not be regarded as including the business of another unless the

other corporation is a mere instrumentality of the first; to establish this it is ordinarily essential that the first corporation own all or substantially all of the stock of the second.

The Commission, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated earnings and profits, the name and address of, and number of shares held by each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 148 (c).)

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